

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

COMPILATION OF FY 1995 AND FY 1996 DOD
FINANCIAL STATEMENTS AT THE DEFENSE FINANCE
AND ACCOUNTING SERVICE, INDIANAPOLIS CENTER

Report No. 96-161

June 13, 1996

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Acronyms

CFO	Chief Financial Officer
DBARS	Departmental Budgetary Accounting and Reporting System
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
FSDB	Financial Statement Data Base
GLDB	General Ledger Data Base
HQARS	Headquarters Accounting and Reporting System
IG	Inspector General
OMB	Office of Management and Budget
USAAA	U.S. Army Audit Agency



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June 13, 1996

**MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE, INDIANAPOLIS CENTER
AUDITOR GENERAL, U.S. ARMY AUDIT AGENCY**

**SUBJECT: Audit Report on the Compilation of FY 1995 and FY 1996 DoD Financial
Statements at the Defense Finance and Accounting Service, Indianapolis
Center (Report No. 96-161)**

We are providing this audit report for information and use. This audit was performed in response to the Chief Financial Officers Act of 1990 as amended by the Federal Financial Management Act of 1994. Management comments on a draft of this report were considered in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

The courtesies extended to the audit staff are appreciated. Questions about this audit should be directed to Mr. Richard B. Bird, Audit Program Director, at (317) 542-3859 (DSN 699-3859), or Mr. John J. Vietor, Audit Project Manager, at (317) 42-3855 (DSN 699-3855). The distribution of this report is listed in Appendix G. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, Department of Defense

Report No. 96-161
(Project No. 5FI-2012.01)

June 13, 1996

Compilation of FY 1995 and FY 1996 DoD Financial Statements at the Defense Finance and Accounting Service, Indianapolis Center

Executive Summary

Introduction. The Defense Finance and Accounting Service, Indianapolis Center, maintains the Army departmental accounting records and compiles the Army General Fund financial statements.

The Chief Financial Officers Act of 1990 as amended by the Federal Financial Management Act of 1994 requires the Inspector General, DoD, to audit financial statements of DoD organizations in accordance with applicable generally accepted Government auditing standards but allows the delegation of the audit work. The Inspector General, DoD, delegated the audit of the Army FY 1995 General Fund financial statements to the U.S. Army Audit Agency but assisted by performing the required audit work at the Defense Finance and Accounting Service, Indianapolis Center.

Audit Objectives. The audit objective was to determine whether the Defense Finance and Accounting Service, Indianapolis Center, consistently and accurately compiled financial data from field entities and other sources into the FY 1995 Consolidated Financial Statements for the Army General Fund. We evaluated the processes, including internal controls and methods, that the Defense Finance and Accounting Service, Indianapolis Center, used to compile the Army FY 1995 General Fund financial statements. We also assessed actions in preparation for the compilation of financial data for the FY 1996 financial statements for the other DoD organizations that are the responsibility of the Defense Finance and Accounting Service, Indianapolis Center. In addition, we examined the controls over the preparation of accounting adjustment vouchers for Defense appropriations other than the Army General Fund. We also reviewed the adequacy of the management control program as it applied to our objectives.

Audit Results. The Defense Finance and Accounting Service, Indianapolis Center, consistently and accurately compiled financial data from field entities and other sources into the FY 1995 Consolidated Financial Statements for the Army General Fund. The efficiency and internal control environment of the compilation processes had significantly improved since FY 1993 (the last time we reported on the compilation process at the Defense Finance and Accounting Service, Indianapolis Center).

See Appendix C, "Other Matters of Interest," for details on improvements in the compilation process.

However, further improvements in the compilation process were needed. The Defense Finance and Accounting Service, Indianapolis Center, could have better explained that variances of up to \$6 billion in financial statement line items from year to year occurred because FY 1995 financial data was not in fact comparable to FY 1994

financial data. Footnoting was incomplete. Also, controls over making 15 auditor-recommended adjustments for about \$19.5 billion and preparing 165 accounting adjustment vouchers needed improvement.

Since our last report, the Defense Finance and Accounting Service, Indianapolis Center, has been assigned responsibility for maintaining accounting records and preparing financial reports for all Defense agencies. We also reviewed the progress of the Defense Finance and Accounting Service, Indianapolis Center, in assuming this new mission. Preparations are not yet complete for the compilation of FY 1996 Chief Financial Officer financial statements for Defense agencies other than the Army. Basic planning and analysis have been completed, and Defense agency data has been integrated into some parts of the process used to compile Chief Financial Officer financial statements. Defense agency financial data that has been integrated into the compilation process, such as the preparation of accounting adjustment vouchers, was included in our review. See Appendix C, "Other Matters of Interest," for details on Chief Financial Officer reporting for Defense agencies.

Part I of this report provides details of our audit.

Summary of Recommendations. We recommend that the Director, Defense Finance and Accounting Service, direct the Director, Defense Finance and Accounting Service, Indianapolis Center, to improve internal controls over the processes used to compile the Chief Financial Officer financial statements. The controls should include:

- o Disclosing the causes for financial statement line item variances in financial statements that occurred because current year financial data was not in fact comparable to prior year financial data.

- o Preparing all required footnotes,

- o Establishing controls to ensure that auditor recommended adjustments are made by the field accounting entity, and

- o Enforcing established voucher control, separation of duties, and documentation standards for the preparation of departmental accounting adjustment vouchers.

Management Comments. The Director, Defense Finance and Accounting Service, concurred with all the audit recommendations. He agreed that year-to-year financial statement line item variances should be explained, but only to the extent that they are not considered operational in nature. The Director agreed that all required footnotes should be prepared, and that the Defense Finance and Accounting Service, Indianapolis Center, has already implemented procedures that allow for tracking the recording of auditor recommended adjustments by field accounting entities. The Director also agreed to subject the adjustment journal voucher process for Defense agencies to the same control procedures used for the adjustment journal voucher process used for the Army General Fund. See Part I for a summary of management comments, and Part III for the complete text of the management comments.

Audit Response. We consider the comments and proposed corrective actions from the Director, Finance and Accounting Service, to be fully responsive to the audit recommendations.

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Part I - Audit Results

Audit Background

Chief Financial Officers Act. Public Law 101-576, the Chief Financial Officers (CFO) Act of 1990, as amended by Public Law 103-365, the Federal Financial Management Act of 1994, requires the annual preparation and audit of financial statements for trust funds, revolving funds, and substantial commercial activities of 23 executive departments and agencies, as well as Government corporations. The CFO Act also requires the Inspectors General (IGs), or appointed external auditors, to audit financial statements in accordance with generally accepted Government auditing standards and other standards established by the Office of Management and Budget.

Audit of the FY 1995 Army General Fund Financial Statements. The Inspector General (IG), DoD, delegated the FY 1995 audit of the Army General Fund financial statements to the U. S. Army Audit Agency (USAAA). The IG, DoD, assisted the USAAA by performing the required audit work at the Defense Finance and Accounting Service (DFAS), Indianapolis Center, including examining processes used to prepare the Army General Fund financial statements.

The Role of the DFAS Indianapolis Center. The DFAS Indianapolis Center provides finance and accounting support to all DoD organizations but especially to the U.S. Army and the independent Defense agencies. The support includes maintaining departmental accounting records and preparing financial statements from both general ledger and status of appropriations financial data submitted by field reporting organizations and other sources. However, the compilation process is complicated by the fact that data submitted to the DFAS Indianapolis Center was not generated by integrated, transaction driven general ledger systems. See Appendix D, "Process Used to Prepare the Chief Financial Officers' Financial Statements," for details.

The FY 1995 Army General Fund Financial Statements. The Army FY 1995 financial statements consisted of the Statement of Financial Position and the Statement of Operations and Changes in Net Position, along with supporting footnotes, supplementary schedules, and a management overview. The Statement of Financial Position reported assets of \$221.7 billion and liabilities of \$7.9 billion as of September 30, 1995. The Statement of Operations and Changes in Net Position reported total revenues of \$59.8 billion and expenses of \$60.8 billion for the fiscal year ended September 30, 1995.

The FY 1996 DoD Financial Statements. The DFAS Indianapolis Center will be responsible for compiling principal CFO financial statements for the Army, the Defense Business Operations Fund (DBOF), and the other Defense agencies for FY 1996. Preparing for this increased workload included assigning reporting responsibility and modifying the microcomputer database application used to compile CFO financial statements. Also, the DFAS Indianapolis Center will consolidate the CFO financial statements for all Defense components for FY 1996. These DoD consolidated financial statements are expected to report

estimated assets of at least \$1.2 trillion and estimated expenses of at least \$300 billion. The preparation of the FY 1996 DoD Consolidated Financial Statements will be audited and reported upon separately. See Appendix C, "Other Matters of Interest," for details on CFO reporting for Defense agencies.

Audit Objective

Our audit objective was to determine whether the DFAS Indianapolis Center consistently and accurately compiled financial data from field organizations and other sources for the FY 1995 Consolidated Financial Statements for the Army General Fund. Specifically, we determined whether:

- o Adequate internal controls were in place and operating during the compilation of the financial statements,
- o Adjustments to financial data were accurate and proper,
- o Financial statements were properly prepared and were materially correct, and
- o Footnotes and management data were supported and consistent with the information included in the financial statements.

We also assessed actions taken by the DFAS Indianapolis Center to prepare for the compilation of FY 1996 financial statements for Defense agencies other than the Army. In addition, we examined the controls over the preparation of accounting adjustment vouchers for Defense appropriations other than the Army General Fund. We also reviewed the adequacy of the management control program as it applied to our objectives.

See Appendix A for a discussion of the scope and methodology related to this audit and discussion of the DFAS Indianapolis Center Management Control Program and management control weaknesses found during our review. See Appendix B for a summary of prior coverage related to the audit objectives.

Compiling the FY 1995 Army General Fund Financial Statements

The DFAS Indianapolis Center needed to improve its process for compiling the Army General Fund financial statements. Footnotes did not adequately explain the causes for large variances of up to \$6 billion in financial statement line items from year to year, and a required footnote was not prepared. Also, controls over making 15 auditor-recommended adjustments for about \$19.5 billion and preparing 165 accounting adjustment vouchers for both Army and other Defense agencies needed improvement. The need for process improvement existed because current guidance was not enforced. As a result, the usefulness of the FY 1995 Army General Fund financial statements was reduced and the possibility of material misstatement existed.

Criteria, Responsibilities, and Procedures

Footnote Disclosure. The American Institute of Certified Public Accountants Statement on Auditing Standards No. 32, "Adequacy of Disclosure in Financial Statements," October 1980, states that "The presentation of financial statements in accordance with generally accepted accounting principles includes adequate disclosure of material matters." The Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," November 29, 1993, states that "the notes to principal statements, which are an integral part of the principal statements, shall provide additional disclosures necessary to make the principal statements fully informative and not misleading." The Financial Accounting Standard Board Accounting Standards, "Financial Statements: Comparative Financial Statements," June 1, 1995, states that "It is necessary that prior year figures shown for comparative purposes be in fact comparable with those shown for those for the most recent period, or that any exceptions to comparability be clearly brought out." The DoD Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity, October 20, 1994, establishes specific requirements for footnotes to principal statements. The DFAS Indianapolis Center's Internal Control and Evaluation Division is responsible for developing the footnotes to the Army General Fund CFO financial statements.

Accounting Adjustment Vouchers. The DFAS Indianapolis Center's Departmental Accounting Reports Division prepares status of appropriations (status) adjustment vouchers for both Army and other Defense agencies. Status adjustment vouchers are used to correct accounting errors and to record the effects of payments and collections in transit on accounts payable and accounts receivable. These adjustments are important because the general ledger data used to prepare the Army General Fund financial statements are forced to agree with the status of appropriations balances affected by the adjustments.

DoD Financial Management Regulation 7000.14R, "Reporting Policy and Procedures," February 12, 1995, states that "the DFAS shall support adequately, and justify in writing, any adjustment to the official accounting records." The regulation also states that the documentation of adjustments should be detailed enough to provide an audit trail. The Departmental Accounting Reports Division issued Standing Operating Procedure #8011 (Revised), "Process for Journal Voucher Preparation and Input to the Standard General Ledger System for Financial Statement Reporting," March 30, 1995, to govern the procedures for preparing the adjustment vouchers. The Internal Control and Evaluation Division is responsible for controlling adjustment vouchers and ensuring that they comply with established requirements.

Footnote Disclosure

As required by Statement on Auditing Standards No. 32, we examined the footnotes prepared by the DFAS Indianapolis Center for the Army FY 1995 General Fund financial statements. We determined that the footnotes could have better disclosed the causes for large variances in financial statement line items from year to year. Also, a footnote required by DoD guidance was not prepared.

Footnote Disclosure of Year-to-Year Variances in Financial Statement Line Item Balances. Footnote disclosures could have better explained the causes for large variances in financial statement line items from year to year. We determined that the FY 1995 Army General Fund CFO financial statements contained nine lines that had large variances in financial statement line items from year to year (see Appendix E, "Year-To-Year Variances," for a list of the 9 lines). Five of the nine lines were not comparable from year to year and should have been discussed in footnotes. The following are two examples of the five lines.

- o **Entity Assets.** Line 1.1 of the Army General Fund FY 1995 Statement of Financial Position showed an FY 1995 balance for other entity assets of \$153 million, a 98-percent decline from the FY 1994 balance of \$7.2 billion. The footnote for this line simply stated that other entity assets "includes items classified as sensitive equipment" but made no mention of the decrease in the value of the line. In fact, the decrease occurred because the DFAS Indianapolis Center did not make an adjustment for Government-furnished materials that had been made in FY 1994. Because it was decided not to make the same adjusting entry for FY 1995 that had been made for FY 1994, the financial data for the 2 years was not in fact comparable. This fact should have been explained in the footnotes to the financial statements.

- o **Revenues from Goods and Services to the Public.** Line 2 of the Army General Fund FY 1995 Statement of Operations showed an FY 1995 balance of \$495.2 million, a 55-percent decline from the FY 1994 balance of \$1.1 billion. There was no footnote. The decline was due to a classification of revenue that was applied in FY 1994 that was not applied in FY 1995.

Compiling the FY 1995 Army General Fund Financial Statements

Because this classification of revenue was not applied in both years, the financial data for the 2 years was not in fact comparable. This fact should have been explained in the footnotes to the financial statements.

If material line items are not comparable from year to year but the lack of comparability is not explained in the footnotes, the meaning of large variances in line item balances may not be properly understood. Incomplete explanations reduce the usefulness of the CFO financial statements.

Footnote on Leases. DFAS Indianapolis Center did not include a required footnote explaining capital leases in the FY 1995 Army General Fund financial statements. DoD Form and Content guidance requires a footnote disclosing the assets held under capital lease, future payments due, and total liability. The FY 1995 Statement of Financial Position included \$5.6 billion in assets under capital lease, but the required footnote was not prepared. DFAS Indianapolis Center personnel stated that the assets under capital lease were covered indirectly in other footnotes. Footnote 1L does contain a paragraph explaining that real property assets held under agreements with foreign governments at overseas locations had been reclassified as assets under capital lease. However, Footnote 15 simply shows that the Army has about \$5.6 billion in assets under capital lease without making clear whether these assets are the same as those discussed in footnote 1L. Also, there is no statement concerning any liabilities other than maintenance the Army has or may incur in regard to these assets. If the required footnote on capital leases had been prepared, these issues could have been clearly presented.

The DFAS Indianapolis Center could have prepared better footnotes for the FY 1995 Army General Fund financial statements. Year-to-year variances that occur because current year financial data is not in fact comparable to prior year data should be carefully explained. Also, all required footnotes should be included with the principal statements. These enhancements to the footnotes would significantly improve the potential usefulness of the financial statements.

Accounting Adjustment Voucher Controls

Making Auditor-Recommended Adjustments at Field Accounting Entities. The DFAS Indianapolis Center did not have controls to ensure that field accounting entities make adjustments already made at departmental level, such as those recommended by auditors. DFAS Indianapolis Center personnel assumed that such adjustments were made by the field accounting entities as part of the following year's beginning balance adjustment process. For FY 1994, there were 15 auditor-recommended adjustments for about \$19.5 billion that should have been made as part of the FY 1995 beginning balance procedures. The adjustments resulted in a net increase in assets, liabilities, and expenses of about \$4.7 billion and a corresponding equity increase of about \$4.7 billion. Our examination of beginning balance vouchers showed that only part of one auditor-recommended adjustment for about \$362 million was made. Because the DFAS Indianapolis Center receives only general ledger trial balances, not

Compiling the FY 1995 Army General Fund Financial Statements

records of individual transactions, there was no way to determine whether the remaining auditor-recommended adjustments had been made during FY 1995. If the adjustments were not made by the field accounting entities, the final trial balances used to prepare the FY 1995 financial statements would be incorrect. For example, if an accounting entity failed to record an auditor-recommended increase in military equipment for \$1 billion and the related increase in equity transferred in without reimbursements, that accounting entity's year-end balance would understate both property and equity by \$1 billion, but the DFAS Indianapolis Center would not be aware of the error. The DFAS Indianapolis Center should establish procedures requiring field accounting entities to submit proof that auditor-recommended adjustments have been made.

Controls Over Preparing Accounting Adjustment Vouchers. Enforcement of established approval, control, input, and documentation standards for preparing accounting adjustment vouchers needed strengthening. We reviewed a series of 167 status accounting adjustment vouchers for about \$16.1 billion prepared by the Departmental Accounting Reports Division. Of the 167 vouchers, 2 were voided and so were not examined.

Army General Fund Status Accounting Adjustment Vouchers. Of the 165 vouchers examined, 52 vouchers for about \$5.9 billion directly related to the Army General Fund status of appropriations. We reviewed these 52 vouchers for enforcement of established approval, control, input, and documentation standards as well as accuracy and accounting logic. Table 1 shows the results of our review.

**Table 1. Status Accounting Adjustment Vouchers
Army General Fund**

<u>Deficiency</u>	<u>Total</u>
Did not have correct signatures	3
Not properly recorded in control log	3
Required improved documentation	29
Totals	35
All vouchers	52
Value (billions)	\$5.9

Of the 52 status accounting adjustment vouchers that directly affected the Army financial statements, 29 required improved documentation. When explained by Indianapolis Center personnel, the documentation was sufficient to support the amount and accounting logic of the adjustments. However, Indianapolis Center Standing Operating Procedures require supporting documentation to be marked and organized so that it can stand alone and not require additional explanation.

Defense Agencies Status Accounting Adjustment Vouchers. Of the 165 vouchers examined, 113 vouchers for about \$10.2 billion related to the Defense Agencies' status of appropriations. We reviewed these 113 vouchers

Compiling the FY 1995 Army General Fund Financial Statements

for enforcement of established approval, control, input, and documentation standards as part of our examination of the DFAS Indianapolis Center's preparation for its FY 1996 Defense agencies reporting responsibilities. Table 2 shows the results of our review.

**Table 2. Status Accounting Adjustment Vouchers
Defense Agencies**

Deficiency	Total
Did not have correct signatures	44
Not properly recorded in control log	2
No supporting documentation	5
Prepared by unauthorized person	1
Totals	52

All vouchers	113
Value (billions)	\$10.2

The DFAS Indianapolis Center did not prepare financial statements for the Defense agencies in FY 1995, so these adjustments had no effect on FY 1995 financial statements. Of the 113 status accounting adjustment vouchers that affected Defense agencies status of appropriations, 44 did not have the correct signatures. In 40 of these 44 cases, a branch chief signed the vouchers twice, once as branch chief and once as division chief. The DFAS Indianapolis Center's established control procedures require independent review at the division level. DFAS Indianapolis Center personnel stated that the branch chief signed as division chief because the assigned division chief was on extended temporary duty during the year-end adjustment process. However, the branch that prepared the Army General Fund status accounting adjustment vouchers, part of the same division, had each of its vouchers reviewed by a division chief from another division and so ensured that an independent review was completed as required. Failure to control and document status accounting adjustment vouchers for Defense agencies could result in errors in other reports made to the U.S. Treasury. Also, failure to correct these management control deficiencies would adversely affect the preparation of financial statements for FY 1996.

Conclusion. If adjustment vouchers are not properly controlled and documented, errors in the adjustment amounts may go undetected, and the risk of material misstatement in the financial statements is unnecessarily increased. The Internal Control and Evaluation Division should ensure that responsible personnel enforce established approval, control, input, and documentation standards for accounting adjustment vouchers.

Recommendations, Management Comments, and Audit Response

We recommend that the Director, Defense Finance and Accounting Service direct the Director, Defense Finance and Accounting Service, Indianapolis Center:

1. Develop and implement procedures for fully explaining circumstances in which prior year figures shown for comparative purposes are not in fact comparable with those shown for the most recent period in the footnotes to the principal statements.

2. Ensure that all required footnotes are prepared and presented with the principal financial statements.

3. Establish procedures requiring field accounting entities to submit proof that auditor-recommended adjustments have been made.

4. Enforce established voucher control, separation of duties, and documentation standards for the preparation of departmental accounting adjustment vouchers.

Management Comments and Audit Response. The Director, DFAS concurred with all audit recommendations. All of the proposed corrective actions were considered fully responsive. The Director, DFAS agreed that year-to-year financial statement line item variances should be explained, but only to the extent that they are not considered operational in nature; all required footnotes should be prepared; procedures will be implemented that allow for tracking the recording of auditor recommended adjustments by field accounting entities; and the adjustment journal voucher process for Defense Agencies will be subjected to the same control procedures used for the adjustment journal voucher process used for the Army General Fund. See Part III for the full text of the management comments.

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Part II - Additional Information

Appendix A. Scope and Methodology

Scope and Methodology

Audit Work Performed. We limited our evaluation of the compilation of the Army FY 1995 General Fund financial statements to an examination of the DFAS Indianapolis Center's departmental processes for consolidating the status and general ledger data. These data were used to prepare the version of the Army statements submitted to auditors on February 5, 1996. Our examination included a review of the following processes:

- o establishment of beginning balances;
- o yearend reporting and certification, including the controls over yearend status data, the Treasury trial balance, and general ledger reconciliations;
- o adjustments to status data;
- o adjustments made directly to the Financial Statements Data Base (FSDB) file; and
- o transfer of the status-adjusted general ledger data to the FSDB and to the Army statements.

Limitations. We did not examine the accuracy of data submitted by field accounting entities or other sources or attempt to reconcile the data with supporting subsidiary records. However, we did compare the Fund Balance With Treasury recorded by the U.S. Treasury for the Army General Fund to the Fund Balance With Treasury reported in the Army financial statements. We also reviewed the closing positions for Army General Fund appropriations for deficit balances and general ledger trial balance submissions for reasonableness.

To achieve the audit objective, we relied primarily on computer-processed data contained in the status system and the General Ledger Data Base (GLDB). We assessed the reliability of this data, including relevant physical security, general, access, and application controls. We found the controls to be adequate. We also conducted sufficient tests of the data. We concluded that the computer-processed data was sufficiently reliable to be used in fulfilling the audit objective. However, field-level systems were not included in this review. Consequently, we can comment only on the reliability of computer processing of data once received within the Indianapolis Center.

Audit Period, Locations, and Standards. We performed this financial statement audit at the DFAS Indianapolis Center from May 1995 through March 1996. The audit was made in accordance with auditing standards established by the Comptroller General, as implemented by the IG, DoD, and with OMB guidance; however, we limited our scope as noted above. The audit included such tests of management controls and management's compliance with laws and regulations as we considered necessary. Appendix F lists the organizations we visited or contacted.

Management Control Program

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We evaluated management controls over the DFAS Indianapolis Center's departmental processes that consolidated the status and general ledger data for preparation of the financial statements. The evaluated management controls consisted of the overall control environment and control procedures at the DFAS Indianapolis Center, as they related to the preparation of the Army FY 1995 General Fund financial statements. Management controls were effective for the yearend reporting and certification process. However, controls were either not in place or were not enforced for preparing footnotes for the CFO financial statements and making accounting adjustments. The DFAS Indianapolis Center did not:

- o adequately disclose the causes for large variances in financial statement line items from year to year,
- o prepare all required footnotes,
- o have effective controls over making auditor-recommended adjustments, or
- o adequately control or document all adjustments made to the financial data.

Reported Control Weaknesses. We evaluated the DFAS Indianapolis Center's process for implementing the DoD Internal Management Control Program and concluded that the implementation was adequate. Although the DFAS Indianapolis Center had not reported the specific management control weaknesses we identified, it reported generic material weaknesses in the preparation of Army financial statements. The DFAS Indianapolis Center reported that its Headquarters Accounting and Reporting System (HQARS) departed from key accounting requirements governing general ledger control as well as system documentation, and that these departures impeded achieving reliable CFO financial statements. The DFAS Indianapolis Center also reported

Appendix A. Scope and Methodology

that these weaknesses will not be fully corrected until all accounting systems that provide accounting data to HQARS comply with all key accounting requirements. The DFAS Indianapolis Center did not report a planned date for compliance. In the interim, the DFAS Indianapolis Center plans to work with the Army to improve the reliability of the financial data used to prepare the financial statements. In this report, we have recommended some additional interim improvements for preparing financial statements and accounting adjustments. These improvements address management control weaknesses.

The management control weaknesses that we identified, and our recommendations for improvements, are discussed in Part I. All recommendations in this report, if fully implemented, will assist the DFAS Indianapolis Center in either correcting the identified management control weaknesses or minimizing their effect until new DoD accounting systems are implemented. These recommendations will also assist the DFAS Indianapolis Center in preparing more accurate and reliable financial statements. No quantifiable monetary benefits will result from correcting the identified management control weaknesses.

Appendix B. Summary of Prior Audits and Other Reports

U.S. General Accounting Office, Report No. AIMD-93-1 (OSD Case No. 9276-E), "Examination of the Army's Financial Statements for Fiscal Years 1991 and 1992," June 30, 1993. The report stated that the DFAS Indianapolis Center made about \$93 billion in adjustments to the departmental general ledger to make it agree with data reported through other operational systems. This \$93 billion included about \$7 billion in unsupported adjustments to general ledger account balances, \$2 billion of which applied to bringing Fund Balance With Treasury in line with Treasury records, because status data were considered to be more reliable. The DFAS Indianapolis Center also made about \$5.7 billion of adjustments and corrections to status data, but could not provide adequate documentation to support some of the adjustments. The General Accounting Office also reported that management controls were ineffective and that data contained in the Army Overview and Supplemental Financial and Management Information were likely to be unreliable. Problems were also discovered in the audit of the FY 1991 statements that had not yet been corrected. These included inaccurate non-financial asset reporting, incomplete recording of liabilities, and unsupported financial statement adjustments. About \$52 billion in adjustments were proposed to improve the accuracy and presentation of the Army FY 1992 financial statements, with only about \$28 billion actually appearing on the statements because DoD did not concur with adjustments related to \$24 billion in unrecorded liabilities.

Office of the Inspector General, DoD, Report No. 94-168, "Defense Finance and Accounting Service Work on the Army's FY 1993 Financial Statements," July 6, 1994. This audit combined the results of audit work completed on both the Army FY 1993 General Fund and DBOF financial statements. Although the IG, DoD, delegated the issuance of an audit opinion to the USAAA, it assisted the USAAA by performing the required audit work at the DFAS Indianapolis Center. The IG, DoD, concluded that the Army DBOF financial statements for FY 1993 were misstated by about \$2.2 billion and the Army General Fund financial statements were misstated by about \$2.7 billion because the DFAS Indianapolis Center failed to detect or correct errors in the financial data submitted to the Army departmental general ledger. Additionally, the DFAS Indianapolis Center did not adequately document about \$9.8 billion of the reviewed status data adjustments and about \$48.3 billion of the reviewed departmental general ledger adjustments. DBOF inventory accounting was not correct, and inputs and adjustments to the departmental general ledger were not properly organized and controlled. There were 10 recommendations to strengthen procedural management controls and address detection and correction procedures for general ledger accounts. The DFAS Indianapolis Center concurred with eight of the recommendations and provided acceptable alternative actions for the other two. At the end of FY 1995, one of the recommendations was still open.

Appendix B. Summary of Prior Audits and Other Reports

U.S. Army Audit Agency, Report No. 95-451, "Audit of the Army's Principal Financial Statements for Fiscal Years 1994 and 1993," March 23, 1995. The report constituted the USAAA opinion on the FY 1994 Army financial statements. The IG, DoD, delegated audit responsibility, including expressing an audit opinion on the Army financial statements, to the USAAA. The USAAA issued a disclaimer of opinion on the financial statements for the following general reasons: 1) accounting systems were unable to generate auditable general ledger information, 2) overstated or unsupported values for several non-financial assets, and 3) DoD policies regarding certain types of liabilities precluded the full disclosure of likely future obligations. The USAAA concluded that while they were unable to satisfy themselves as to the fairness of the data presented in the financial statements, Army leaders were demonstrating what was believed to be a sincere commitment to effectively and efficiently manage resources under their control. Audit results showed that considerable improvements had been made in that area, but there were still substantial improvements needed. The report made no recommendations on correcting the identified problems.

U.S. Army Audit Agency, Report No. HQ 94-451, "Audit of the Army's FY 1993 Financial Statements, DoD Policy Issues," August 31, 1994. The USAAA reported on DoD accounting policies that materially affected the Army Statement of Financial Position. The USAAA concluded that DoD guidance regarding the reporting of probable contingent liabilities did not comply with OMB guidance. This guidance directed that probable contingent liabilities be recorded on the Statement of Financial Position. The Office of the Comptroller, DoD, did not concur with the USAAA recommendation to change its policy, stating the estimated costs were better classified as potential claims against future budgetary resources rather than contingent liabilities. The USAAA also concluded that the Army, based on DoD guidance, incorrectly excluded all munitions held as war reserves at intermediate supply points and military installations from the FY 1993 financial statements. The Office of the Comptroller, DoD, stated that the Federal Accounting Standards Advisory Board was currently considering the issue and it would wait until the Board made a recommendation.

U.S. Army Audit Agency, Report No. HQ 94-450, "Audit of the Army's FY 1993 Financial Statements," June 30, 1994. The report was the USAAA opinion on the FY 1993 Army General Fund financial statements. The IG, DoD, delegated audit responsibility, including expressing an audit opinion on the Army FY 1993 financial statements, to the USAAA. The USAAA issued a disclaimer of opinion based on deficiencies in the accounting systems used to report financial data, policies used within the DoD and the Army, and amounts presented in the financial statements. The USAAA also identified management control weaknesses regarding the protection of Army assets, assurance of material compliance with laws and regulation, and assurance of no material misstatements in the financial statements. The USAAA also reported on instances of material noncompliance with laws and regulations.

Appendix C. Other Matters of Interest

This appendix describes:

- o Improvements the DFAS Indianapolis Center has made in the efficiency and internal control environment of the compilation processes since FY 1993 (the last time we reported on the compilation process at the DFAS Indianapolis Center); and

- o The DFAS Indianapolis Center's preparation for compiling CFO Financial Statements for Defense Agencies.

Improvements in the Compilation Process for CFO Financial Statements at the DFAS Indianapolis Center

Improvements in Controls Over Accounting Adjustments. Since FY 1993, the DFAS Indianapolis Center continued to enforce the management controls already in place while making significant improvements. Specific improvements included:

- o defining clear separation of duties among the preparers, approvers, and processors of accounting adjustments;

- o establishing audit trails so that external auditors could identify the number and dollar value of accounting adjustments made;

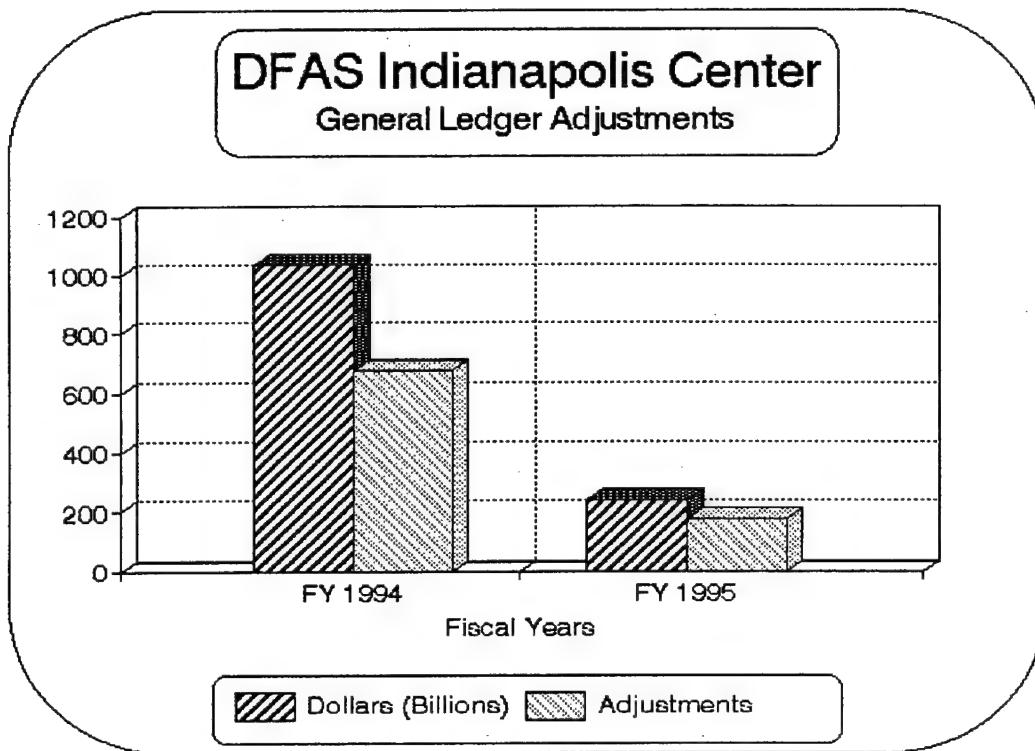
- o classifying accounting adjustments by type;

- o providing a written description of the purpose of each accounting adjustment; and

- o attaching supporting documentation to most accounting adjustment vouchers.

Increased Use of Automated Analysis and Procedures. The DFAS Indianapolis Center has continued to exploit automated analysis and assistance to make the compilation process more effective. Some examples of exploitation of automated analysis follow.

- o In FY 1995, the use of computer-prepared vouchers to automatically compute and prepare adjustments made manually in previous years, including the adjustment of general ledger data to match status data, materially reduced the total number (from 675 to 172, or minus 75 percent) and amount (from \$1,036.9 billion to 238.9 billion, or -77 percent) of adjustments from FY 1994 levels;



o In FY 1995, the use of computer analysis to identify abnormal balances and very large or unexpected year-to-year changes in the general ledger ending balances submitted by external accounting entities identified several errors that were corrected by the DFAS Indianapolis Center.

Conclusion. Our assessment of the process currently used to compile the Army General Fund CFO Financial statements is generally favorable, given that the current process is only an interim solution. However, the use of status and expenditure data is an unacceptable means to compile the Army statements. We believe that the Army statements, taken as a whole, will not be auditable until a transaction-driven, integrated accounting system based on general ledger accounting is implemented Army-wide.

Compilation of CFO Financial Statements for Defense Agencies

Scope of the CFO Financial Statements Compilation Task. The DFAS Indianapolis Center will be responsible for compiling three principal CFO financial statements for FY 1996:

- o The Department of the Army General Fund CFO financial statements,
- o The Defense Business Operating Fund CFO financial statements, and
- o The "Other Defense Organizations" CFO financial statements.

These principal financial statements are actually a summary of 12 OSD Principal Staff Assistant CFO financial statements. The 12 financial statements are themselves summaries of 45 separate DoD agency-, fund-, or account-level financial statements.

In addition, the DFAS Indianapolis Center will prepare the consolidated "Total Department of Defense" CFO financial statements and the related eliminating entries. The DFAS Indianapolis Center also arranges for the printing and physical production of other DoD CFO financial statements such as the Air Force, Navy, and Army Corps of Engineers General Funds.

The Process to be Used to Prepare the CFO Financial Statements for FY 1996. The DFAS Indianapolis Center will use the same process to compile all 60 DoD CFO financial statements for FY 1996 that it used to compile the FY 1995 Army General Fund CFO financial statements. See Appendix D, "Process Used to Prepare the Chief Financial Officers Financial Statements," for a description of this process. However, the personal computer database application used to actually assemble the financial statements has to be modified to accomplish this task for all organizations and appropriations. The modifications, due to be completed and tested during the summer of 1996, include conversion to the Microsoft Windows environment and to a completely table-driven method of operation. The modified system, to be called the "Comprehensive Reporting System," will also be used for direct reporting of general ledger trial balances to the U.S. Treasury.

Appendix D. Process Used to Prepare the Chief Financial Officers Financial Statements

The DFAS Indianapolis Center prepares the Army CFO financial statements from unconsolidated financial data. However, neither the DFAS Indianapolis Center's Headquarters Accounting and Reporting System (HQARS) nor its supporting accounting subsystems conform to the general ledger method of accounting. In addition, the financial data submitted to the DFAS Indianapolis Center were not generated by an integrated, transaction driven general ledger. As a result, the DFAS Indianapolis Center must use a complex process to combine financial information from many accounting subsystems and compile the Army financial statements.

a. The closing balance used to prepare the prior year's Army statements are transferred to the current year beginning general ledger balances.

b. Status of appropriations data accumulated in the HQARS module called the Departmental Budget Accounting and Reporting System (DBARS) during the fiscal year are corrected to match certified status reports. At the end of the fiscal year, certified status of funds reports are transmitted to DBARS for all Operating Agencies. The certified reports are then compared with the corresponding status data stored in DBARS, and the status data are adjusted to match the certified reports.

c. The status data are reconciled to the net expenditures recorded by the U.S. Treasury. DFAS Indianapolis Center personnel extract current year net collection and disbursement data from DBARS by appropriation, creating a file called the Balance Forward. The same data are then obtained from the U.S. Treasury via an interactive system. Indianapolis Center personnel then compare the Balance Forward with the Treasury data. All differences are researched and reconciled to the penny.

d. Indianapolis Center personnel then make departmental adjustments to the status data. These adjustments allow for adjusting the status data to reflect the effect of in-transit and unmatched transactions on accounts payable and accounts receivable; correcting bulk errors due to accounting system deficiencies; meeting special reporting requirements; or adding departmental-level information not available or accounted for by the field accounting systems.

e. Indianapolis Center personnel consolidate the financial data reported directly into the departmental general ledger from the field accounting activities and stored in the GLDB into a microcomputer data base, which we will refer to as the Financial System Data Base (FSDB). The FSDB contains two files. One is a summary-level data base used to prepare the Army statements. This file is called SOURCE. The other file is a more detailed data base used for research. This detailed file is called SOURCEOA.

Appendix D. Process Used to Prepare the Financial Statements

f. Indianapolis Center personnel then make adjustments directly to the SOURCE file. These direct adjustments are used to enter Intra-Army eliminations; estimates for future expenses such as Workmen's Compensation payments; information on non-financial resources received as hard-copy or electronic reports from activities such as the Army Materiel Command or the National Guard Bureau; and departmental expenditures for receipt accounts. Direct adjustments are also used to change the financial information in the general ledger so that the financial resources reported in the Army statements agree with status system and U.S. Treasury reports.

g. A microcomputer program called the Financial Statement Application converts the SOURCE file into the basic Army statements. The application uses several other files to perform the conversion:

- o A list of appropriations to be included in the Army statements (the fund table),
- o A crosswalk that directs general ledger accounts to the correct financial statement line (the map), and
- o The fixed text portion of the financial statements (the title table).

h. Indianapolis Center personnel add footnotes, supplementary schedules, and an overview section to the basic financial statements produced by the application to create the initial version of the Army statements. This is the version submitted for audit. However, this initial version generally does not include complete or final versions of the footnotes, overview, or supplementary schedules.

i. The initial version of the Army statements is modified to reflect adjustments due to audit and other changes, and to include the audit opinion. This version is the audited submission.

The process described in subparagraphs a. through i. will also be used by the DFAS Indianapolis Center to prepare all CFO financial statements for FY 1996.

Appendix E. Year-To-Year Variances

The FY 1995 Army General Fund CFO financial statements contained 9 lines with large variances (the change from FY 1994 to FY 1995 was greater than \$500 million and at least 25 percent). The nine lines are listed in Table 2.

Table 2. Material Year-to-Year Variances (FY 1995)
(Dollars in Millions)

Statement of Financial Position			
Line	FY 1995	FY 1994	Change (Percent)
Advances and Prepayments	\$ 89.8	\$ 640.8	-86
X Other Entity Assets	\$ 153.0	\$ 7,196.2	-98
Non-Entity Assets: Fund Balance With Treasury	\$ 354.7	\$ 924.0	-62
X Accounts Payable (Federal)	\$ 1,070.4	\$ 2,318.9	-54
X Accounts Payable (Non-Federal)	\$ 1,307.6	\$ 64.3	+1933
Cumulative Results of Operations	\$ -2,241.8	\$ 1,147.1	-295
Statement of Operations (and Changes in Net Position)			
Line	FY 1995	FY 1994	Change (Percent)
X Revenue From Sales To The Public	\$ 495.2	\$ 1,111.6	-55
X Cost of Goods Sold To The Public	\$ 495.2	\$ 1,022.8	-52
Non-Operating Changes	\$ -10,962.2	\$ -4,990.1	+120

"X" indicates lines that are not in fact comparable between FY 1994 and FY 1995 because of changes in accounting policy, accounting estimate, or classification.

Appendix F. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller), Washington, DC

Department of the Army

U.S. Army Audit Agency, Alexandria, VA

Other Defense Organizations

Defense Finance and Accounting Service, Arlington, VA

Defense Finance and Accounting Service, Indianapolis Center, Indianapolis, IN

Financial Systems Organization, Indianapolis, IN

Financial Systems Activity, Indianapolis Center, Indianapolis, IN

Defense Information Systems Activity, Western Hemisphere, Fort Ritchie, MD

Defense Megacenters, Denver, CO

Appendix G. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Assistant to the Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Other Defense Organizations

Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service, Indianapolis Center

Non-Defense Federal Organizations

Office of Management and Budget
National Security and International Affairs Division, Technical Information Center,
U.S. General Accounting Office,
U.S. Department of Education, Office of the Inspector General

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on National Security
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Director, Defense Finance and Accounting Service Comments



DEFENSE FINANCE AND ACCOUNTING SERVICE
1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

DFAS-HQ/GC

MAY 29 1996

MEMORANDUM FOR ACTING DIRECTOR, FINANCE AND ACCOUNTING
DIRECTORATE, INSPECTOR GENERAL, DEPARTMENT
OF DEFENSE

SUBJECT: DoDIG Draft Audit Report on Compilation of FY 1995 and
1996 DoD Financial Statements at the Defense Finance
and Accounting Service, Indianapolis Center (Project
No. 5FI-2012)

DFAS has reviewed the draft audit report findings and
recommendations. Attached are our comments and responses to the
recommendations.

If you have any questions, my point of contact on this audit
is Mr. Thomas Tresslar, DFAS-HQ/GC. He may be reached on
(703) 607-1120 or DSN 327-1120.

A handwritten signature in dark ink, appearing to be "Tm", written over a horizontal line.

Thomas F. McCarty
Deputy Director for General
Accounting

Attachment
as stated

cc:DFAS-HQ/PA
DFAS-IN/AHFC

Draft Audit Report on Compilation of FY 1995 and
FY 1996, DoD Financial Statements at Defense Finance and
Accounting Service, Indianapolis Center (PROJECT NO. 5FI-2012.01)

General DFAS comments:

Page 2 of the report - The Role of the DFAS Indianapolis Center. "However, because the Army accounting subsystems do not support general ledger accounting,....." This is confusing to the reader since the previous sentence in the paragraph talks about "general ledger data submitted by the field." Obviously, the accounting subsystems do support general ledger accounting since the accounting subsystems are creating general ledger trial balance submissions to DFAS-IN on a monthly basis. We believe that the statement should read that the "compilation process is complicated by the fact that the data submitted to DFAS-IN was not generated by integrated, transaction driven general ledgers." This recommendation would also apply to the first paragraph on page 21, Appendix D.

AUDIT RECOMMENDATION 1. The Director, Defense Finance and Accounting Service(DFAS) direct the Director, DFAS-IN to develop and implement procedures for fully explaining circumstances in which prior year figures shown for comparative purposes are not in fact comparable with those shown for the most recent period in the footnotes to the principal statements.

DFAS RESPONSE 1. Concur. The current procedures regarding disclosure issues need to be reviewed to determine where improvements can be made. This past year we have increased our use of comparative data to improve the usefulness of the footnotes. Additionally, we have attempted for the first year since we started CFO reporting to standardize our presentation of the footnotes in conformance with the Office of Management and Budget and Department of Defense "CFO Form & Content Guidance." The auditors have surfaced comparability issues relating to changes in classification and changes in estimates. In past years, due to the evolutionary process surrounding the format and presentation of the CFO financial statements, many account reclassifications were required to be completed. These reclassifications led to frequent material variances being reflected in the financial statements.

This year, as in past years, DFAS-IN provided auditors written explanations for the material variances in lieu of separate disclosures in the footnotes. However, in future years we plan to include in the footnotes the same information given to the auditors for those cases where the material variance can be quantified and directly attributed to specific changes.

We will not, of course, attempt to "explain" those cases where the variances can't be directly attributed to changes in a) accounting principles, estimates, or the reporting entity; b) error in previously issued financial statements; c) changes in classification; and d) events or transactions substantially different from those accounted for in previously issued statements. In other words, variances that are operational in nature should not be "explained away" in the footnotes simply because they are smaller or larger than in previous years. In fact, we don't believe this is the intent of the recommendation since attempts to do so would only add subjective management language to the footnotes. We agree with the auditors that there is always room for refinements on footnote disclosures. However, disclosure needs to be on a case by case basis and not applied with a broad brush approach. Estimated completion date to implement additional disclosures is 30 September, 1996.

RECOMMENDATION 2. The Director, DFAS direct the Director DFAS-IN to ensure that all required footnotes are prepared and presented with the principal financial statements.

DFAS RESPONSE 2. Concur. All required footnotes should be prepared. The report specifies the footnote related to Capital Leases. During FY 1995, assets that had been previously classified as real property assets were reclassified to Capital Leases in order to comply with DoD accounting policy found in DoD Financial Management Regulation, Chapter 7, paragraph 070308 (b) 1. DFAS-IN chose to disclose this in Footnote (1. L) "Summary of Significant Accounting Policies."

While these assets are shown under general ledger account 1810 (Capital Leases) there was no intent to record the offsetting liability at the time of the reclassification. In other words, this reclassification is simply a method of segregating overseas real property assets from stateside real property assets. In order to avoid confusion in the future, DFAS-IN will add additional wording to footnote 15 (shows breakout of Property, Plant, and Equipment) to prevent any misinterpretation by the reader. The change will be reflected in the FY 1996 financial statements.

RECOMMENDATION 3. The Director, DFAS direct the Director DFAS-IN to establish procedures requiring field accounting entities to submit proof that auditor-recommended adjustments have been made.

DFAS RESPONSE 3. Concur. DFAS-IN has already established procedures that allow DFAS-IN to track auditor recommended adjustments that have been made by the field. Copies of journal vouchers are currently being submitted as verification of adjustment. The implementation date of this procedure change was February, 1996.

RECOMMENDATION 4. The Director, DFAS direct the Director DFAS-IN to enforce established voucher control, separation of duties, and documentation standards for the preparation of departmental accounting adjustment vouchers.

DFAS RESPONSE 4. Concur. Procedures are in place and we attempt to have zero defects. However, with the rapid pace of year-end report processing, we have not yet managed to reach that point. However, as noted in the report, the observed deficiencies with Army General Fund vouchers were minimal with all vouchers determined to be appropriate for input to the accounting systems. The report also notes that this was the first year the auditors looked at the voucher process for Defense Agencies. In FY 96, DFAS-IN will be preparing financial statements for the Defense Agencies. Consequently, DFAS-IN will bring the Defense Agencies' adjustment process under the same internal control procedures developed for the Army General Fund. Estimated completion date is October 1996.

Audit Team Members

This report was prepared by the Finance and Accounting Directorate,
Office of the Assistant Inspector General for Auditing, DoD.

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INTERNET DOCUMENT INFORMATION FORM

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